



# State of North Carolina Office of the State Controller

Michael F. Easley, Governor

Robert L. Powell, State Controller

The Honorable Michael F. Easley, Governor  
Members of the North Carolina General Assembly  
Citizens of North Carolina

It is our pleasure to furnish you with the 2002 Comprehensive Annual Financial Report (CAFR) of the State of North Carolina in compliance with G.S. 143B-426.39. This report has been prepared by the Office of the State Controller. Responsibility for both the accuracy of the data and the completeness and fairness of the presentation, including all disclosures, rests with the State government and this office. To the best of our knowledge and belief, this financial report is complete and reliable in all material respects. We believe all disclosures necessary to enable you to gain an understanding of the State's financial activities have been included.

Although the State budgets and manages its financial affairs on the cash basis of accounting, G.S. 143-20.1 requires the Office of the State Controller to prepare a comprehensive annual financial report (CAFR) in accordance with generally accepted accounting principles in the United States of America (GAAP). Except for exhibits and notes clearly labeled otherwise, this CAFR has been prepared in accordance with GAAP.

For the convenience of users we have divided this comprehensive annual financial report into three major sections, described as follows:

- The **introductory section** includes this transmittal letter and the State's organization chart, including a listing of principal State officials.
- The **financial section** includes management discussion and analysis, the basic financial statements (government-wide financial statements, fund financial statements, and notes), other required supplementary information, the combining and individual fund financial statements, and schedules.
- The **statistical section** includes selected financial, non-financial and demographic information, much of which is presented on a ten-year basis, as well as required supplementary information.

Management of the government is responsible for establishing and maintaining an internal control structure designed to ensure that the assets of the State are protected from loss, theft or misuse and to ensure that adequate accounting data are compiled to allow for the preparation of financial statements in conformity with generally accepted accounting principles. The internal control structure is designed to provide reasonable, but not absolute, assurance that these objectives are met. The concept of reasonable assurance recognizes that: (1) the cost of a control should not exceed the benefits likely to be derived, and (2) the valuation of costs and benefits requires estimates and judgments by management.

GASB Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, requires that management provide a narrative introduction, overview and analysis to accompany the Basic Financial Statements in the form of management discussion and analysis (MD&A). This letter of transmittal is intended to complement MD&A and should be read in conjunction with it. The MD&A can be found immediately following the Independent Auditor's Report.

MAILING ADDRESS  
1410 Mail Service Center  
Raleigh, NC 27699-1410

Telephone: (919) 981-5454  
Fax Number: (919) 981-5567  
State Courier: 56-50-10  
Website: [www.osc.state.nc.us](http://www.osc.state.nc.us)

LOCATION  
3512 Bush Street  
Raleigh, NC

An Equal Opportunity/Affirmative Action/Americans With Disabilities Employer

## *Profile of the Government*

### *State Reporting Entity and Its Services*

The State of North Carolina entity as reported in the CAFR includes all fund types of the departments, agencies, boards, commissions and authorities governed and legally controlled by the State's executive, legislative and judicial branches. In addition, the reporting entity includes legally separate component units for which the State is financially accountable. The component units are discretely presented in the government-wide financial statements. The State's discretely presented major component units are the University of North Carolina System; the State's community colleges; Golden LEAF, North Carolina Housing Finance Agency, and North Carolina State Education Assistance Authority. The criteria for inclusion in the reporting entity and its presentation are defined by the Governmental Accounting Standards Board (GASB) in its GASB Codification Section 2100. These criteria are described in Note 1 of the accompanying financial statements.

The State and its component units provide a broad range of services to its citizens, including public education; higher education; health and human services; economic development; environment and natural resources; public safety, corrections, and regulation; transportation; agriculture; and general government services. The costs of these services are reflected in detail and in summary in this report.

### *Budgetary Control*

In addition to internal controls discussed previously, the State maintains budgetary controls. The objective of these budgetary controls is to ensure compliance with legal provisions embodied in the annual appropriated budget approved by the General Assembly. Activities of the General Fund and most departmental special revenue funds are included in the annual appropriated budget. The State Highway Fund and the Highway Trust Fund, the State's major special revenue funds, are primarily budgeted on a multi-year basis. Capital projects are funded and planned in accordance with the time it will take to complete the project. The level of budgetary control (that is, the level at which expenditures cannot legally exceed the appropriated amount) is exercised at both the departmental and university level by way of quarterly allotments, with allotment control exercised by the State Controller, and on the program line-item levels requiring certain approvals by the Director of the Budget. Legislative authorization of departmental expenditures appears in the State Appropriation Bill. This "Certified Budget" is the legal expenditure authority; however, the Office of State Budget and Management (OSBM) may approve executive changes to the legal budget. This results in the "Final Budget" presented in the required supplementary information.

## *Economic Condition and Outlook*

### *National Situation*

The primary factors affecting the nation's economy during the period ending June 30, 2002 were the terrorist attacks of September 11 and the continuing impact of the stock market crash.

During the summer of 2001, economists were noting that the economy seemed to be recovering from the slowdown that had begun the past winter. This seemingly optimistic viewpoint was supported by a number of indicators including the monthly survey of purchasing managers, falling energy prices, federal tax cuts robust housing refinancing activity, and stable consumer spending.

The optimism vanished on September 11. The first impact of the terrorist actions was a sharp drop in consumer spending during the latter part of September as consumer confidence dropped by 20 percentage points. When retail activity slowed, manufacturers discovered they had excess inventory and began paring production. This led to fewer hours for workers and eventually forced layoffs. The loss of income led workers to cut back on spending even more and the downward spiral typical of a recession had begun.

Compounding the problem was the prolonged pullback in capital spending. The trigger for this decision by executives was the fact that the 2000-2002 economy was characterized by the steepest decline in corporate profits in over five decades. This factor, coupled with the crash of technology and telecommunications stocks beginning in March 2000, led companies to reduce spending on new facilities and equipment, even in the face of very favorable interest rates.

The recovery from the events of September 11 has been the most sluggish in decades. The first stage of the turnaround, beginning last November, was fueled by a combination of additional interest rate cuts, rapid money supply growth, and aggressive fiscal policy (tax cuts, federal disaster assistance). In addition, the level of business inventories fell by a record amount during the fourth quarter of 2001, setting the stage for a ramping up of production.

Around March of this year, the recovery began to experience what some economists are calling a "soft spot." This loss of momentum was similar to the temporary slowdown experienced in late 1991, just six months after the beginning of the recovery from the Gulf War. In fact, the 1991-93 recovery stalled out three times before a more permanent acceleration took place in mid-1993.

At the end of the 2001-02 fiscal year economic indicators were starting to show signs of improvement. Examples included unemployment claims, retail activity, money supply growth, and record refinancing activity due to the lowest mortgage rates in 40 years. This led many economists to forecast 3-4% real (inflation-adjusted) economic growth for the second half of the calendar year.

There is reason for concern about the fragility of the recovery even though positive signs are popping up every day. First is the continued weakness in equity prices, especially for NASDAQ stocks (down 76% from their 2000 peak). This has devastated the value of 401(k) balances and other sources of savings, causing a drop in consumer confidence. This pattern is the converse of the 1995-99 experience, when skyrocketing stock prices provided fuel for a consumer spending binge through the "wealth effect."

In addition, investors and consumers have been shaken by the accounting fraud and the potential military action against Iraq. A final concern is the mountain of debt taken on by consumers and businesses during the favorable impact of the free-spending 1990s. To date, the debt overhang for individuals has not been a problem due to the impact of low mortgage rates on the demand for housing and incentive-driven demand for vehicles. Once refinancing slows and the bubble in housing prices breaks, the underpinning for the unusually stable spending levels during this recession may evaporate.

The final issue has to do with the prolonged decline in business investment. Many manufacturers continue to experience excess capacity and add new facilities until demand improves. In addition, they are reluctant to rehire laid off workers, preferring to extend the workweek of the employees and bring in temporary workers. Until a major turnaround in stock prices occurs or we get additional federal monetary or fiscal stimulus, we think that the national recovery will continue to be sluggish. The good news is that the combination of depressed inventories and historically low interest rates should prevent the economy from going back into a recession.

## *State Prospects*

One of the primary characteristics of the 2001 recession was the impact on the manufacturing sector. This is important to North Carolina because 18% of nonagricultural employment is in manufacturing in our state versus 12% nationally. A more important measure might be the share of gross state product tied to manufacturing: around 23% in North Carolina versus 17% for the United States.

The decline in manufacturing jobs did not begin with the 2001 recession. Data compiled by the Employment Security Commission show that manufacturing experienced a fairly rapid recovery from the 1990-91 recession, with job growth of 2.6% in 1993. In fact, the “boom and bust” nature of manufacturing is one reason why the state’s economy grew 33% faster than the national experience following the 1981-82 recession and 45% faster following the Gulf War downturn. In fact, North Carolina was the fifth fastest growing state during the 1992-94 period.

Manufacturing employment began a steady decline in mid-1995 as the national economy experienced a mild slowdown following the Fed rate hikes in 1994. The rate of decline began to accelerate in February 2001 and peaked at an 8.5% year-over-year rate in late 2001. Particularly hard hit were the textile and apparel sectors, dropping over 15% annually by the spring of 2001.

There are some signs that the state’s economy has begun to improve. For one thing, the unemployment rate has dropped from 6.9% in April to 6.0% in October and we have seen improvement in the unemployment claims numbers. State sales tax receipts during the quarter ending September 30 were up 1.7% over the same quarter last year and increased 2.3% during the second calendar quarter. This compares to -2.0% for the first quarter and -3.5% for the final quarter of 2001. Unit sales of cars and light trucks rose 2.9% in May and June this year. Finally, real estate conveyance tax collections, levied on a “percent of value” basis, continue to benefit from favorable mortgage rates.

Even with the recent improvements, the State is budgeting on the basis of a continued sluggish recovery. This would be very different from the explosive growth after the last two recessions. One reason is the continued weakness of tech stock prices. As the state has diversified away from the traditional manufacturing industries (textiles, apparel, furniture, and tobacco) to electronics and other technology-oriented companies, we have become more vulnerable to problems in the new sectors.

A classic example is the experience of the Catawba Valley region (Hickory). During the late-1990s, this area had an unemployment rate as low as 1.5% due to the explosive growth of fiber optic manufacturing. Now, the unemployment rate in this county is 9.4%, one of the highest rates in the state. We are concerned that it may take some time for the nation’s telecommunications companies to work down excess inventory.

In addition, it is not clear how areas affected by the displacement of workers in traditional industries will recover. The prevailing view of many local officials is that not only are the jobs lost in recent years the textile, apparel, and furniture sectors gone forever but the shift away from U.S. production is spreading to other types of manufacturing operations.

### **Key Economic Forecast Variables**

(% Change Unless Noted)

	<b>Fiscal Year 2001-2002</b> <b><u>Actual</u></b>	<b>Fiscal Year 2002-2003</b> <b><u>Budgeted</u></b>
<b><u>National</u></b>		
Real Economic Growth*	1.9%	1.4%
Real Consumer Spending*	3.0%	2.1%
Industrial Production	-4.0%	0.6%
Nominal Personal Income	3.3%	1.9%
Consumer Price Index	1.8%	2.3%
Short-Term Interest Rates	2.3%	1.8%
Pre-Tax Profits (Calendar Yr.)	-17.9%	-7.5%
<b><u>North Carolina</u></b>		
Total Employment	-1.1%	-1.4%
Manufacturing Employment	-7.1%	-4.5%
Unemployment Rate	6.3%	7.4%
Personal Income	1.3%	1.8%

\*Adjusted for inflation

— *Economic analysis prepared by David Crotts*  
*Fiscal Research Division*  
*North Carolina General Assembly*  
*November 15, 2002*

## *Issues and Observations*

During fiscal year 2002, the Governor, the General Assembly, and the departments and agencies of State government worked to address key issues facing State government and the citizens of North Carolina.

### *Fiscal Accountability and Reporting*

While this report presents the financial condition of the State on a GAAP basis, it is important to note some of the budget and program realities that contributed to our current condition. With the adoption of the General Fund budget for fiscal year ended June 30, 2003, North Carolina will have experienced its third straight year in which spending needs exceeded recurring revenues. This problem has been increased by the economic downturn experienced nationally and in North Carolina. The increase in spending needs is attributed to enrollment growth in the public schools and higher education institutions along with continued increased costs in the health and human services areas such as Medicaid and children services. The result is that North Carolina has spent more money than it has realized in the General Fund during the last four consecutive years.

In order to meet the constitutional requirement of a balanced budget for the General Fund, the Governor has exercised his constitutional powers through the enactment of Executive Orders to control spending and to identify resources to meet spending requirements. Among these resources are the Highway Trust Fund, the Tobacco Trust Fund, agency special funds, and reductions to employer contributions to some of the State retirement systems. State agencies and institutions have been operating under Executive Orders since February 2001. The current Executive Order allows spending at an average of 96.5% of the authorized General Fund budget for fiscal year 2003.

Because of the budget shortfalls, the need to use State reserves, and the inability to replenish reserves, the result has been an overall reduction in the net worth of the General Fund (GAAP basis) component of the State budget. In the last three years, the unreserved balance has gradually declined to its current level of negative \$575 million for the fiscal year ended June 30, 2002. The Savings Reserve Account balance was used to balance the budget in fiscal year 2001, and the General Assembly authorized new funds to replenish that reserve in fiscal year 2002. But the Savings Reserve Account balance again was required to manage the budget shortfall for fiscal year 2002. As of June 30, 2002, the Savings Reserve had a zero balance.

For fiscal year 2003 through December 11, \$215.6 million has been set aside in the Governor's Executive Order Reserve and is available to manage any potential budget shortfall that may occur. It is important to note, however, that some of these funds will be needed for the continued recovery of eastern North Carolina from the aftermath of Hurricane Floyd. This Reserve coupled with spending restrictions and zero economic revenue growth are the tools the Governor is using to manage the 2003 budget.

In August 2002, Moody's investors service advised North Carolina of a downgrade in its credit from AAA to Aa1 representing the first time since 1960 that North Carolina had less than AAA credit. Moody's advised that the North Carolina budget had been under too much financial strain for too long and that the North Carolina economy was not sufficient to retain our rating at this time. While the rating service praised the strength of executive powers available to insure a balanced budget, they cited lack of structural balance, a weakened GAAP balance sheet, and the continued reliance on non-recurring resources as major factors in the downgrade. They made specific note of the reversal of GAAP balances that have reversed from positives to negatives in a relatively short period of time.

Challenges continue to exist for State government financial and program managers as we move further into this decade. The Governor will propose his 2003-05 budget to the 2003 Session of the General Assembly and many of the fiscal issues will continue into this legislative

session. More discussion of the financial issues of North Carolina can be found in the Management's Discussion and Analysis (MD&A) section of this document.

## *Financial Information*

The MD&A provides an overview of the State's financial activities addressing both governmental and business-type activities reported in the government-wide financial statements. In addition, MD&A focuses on the State's major funds: the General Fund, the Highway Fund and the Highway Trust Fund.

### *Pension and Other Post- employment Benefits*

**Pensions.** The State contributes to the Teachers' and State Employees' Retirement System, the Consolidated Judicial Retirement System, the Legislative Retirement System, the Firemen's and Rescue Squad Workers' Pension Fund, the Supplemental Retirement Income Plan of North Carolina, and the North Carolina National Guard Pension Fund. The Local Governmental Employees' Retirement System is administered by the State but the State is not a participant.

The retirement systems experienced a total return from investments of -4.34% for the one-year period, a return of 0.62% for the three-year period and a return of 5.97% for the five-year period, ended June 30, 2002. These returns are among the better results for public pension plans in the United States, and reflect the conservative asset allocation and attention to investment quality that have guided the plans investment policy. Recent reports indicate that the North Carolina Retirement System investment performance (all pension plans under management) was among the top 12% of all public plans for the last 12 months, and among the top 9% for the past five years for the period ended September 30, 2002.

The Teachers' and State Employees' Retirement System (TSERS), the largest of the pension trust funds, continued to be fully funded, based on the December 31, 2001 actuarial valuation. Specifically, the TSERS was funded at 111.6%, with the actuarial value of assets of \$42.1 billion exceeding the actuarial accrued liability of \$37.7 billion by \$4.4 billion at December 31, 2001. Employer contributions to the TSERS decreased by \$110.3 million, or 35.7% from the prior fiscal year. Investment balances declined by \$2.8 billion, or 6.3% from the prior fiscal year, with a net investment income loss of \$1.9 billion representing a decline in net earnings of \$811 million, or 75.3% from the prior year. The TSERS experienced a \$130.8 million increase in benefit payments to retirees, an increase of 7.7% from fiscal year 2001.

**Employee and Retiree Health Insurance.** The State Health Plan (reported as a component unit for fiscal year 2001) provides comprehensive major medical care for employees and retirees of the State and its participating component units, and it allows for optional coverage of employee and retirees' dependents. This care is also extended to employees and retirees of the Local Education Agencies (LEAs), which are not part of the State's reporting entity. Coverage is self-funded by contributions to the State Health Plan (the Plan), a proprietary component unit of the State. Contributions for employee and retiree coverage are made by the State, its participating component units, and LEAs. Contributions for dependent coverage are made by employees and retirees. Coverage is also extended to certain individuals as an other postemployment benefit. The Plan pays most expenses that are medically necessary and eligible for coverage based on usual, customary and reasonable allowances. Claims are subject to specified annual deductible and copayment requirements. The Plan disallows claims in excess of a lifetime maximum of \$5 million.

As of July 1, 2001, an estimated \$240 to \$300 million of cost savings for the State Health Plan were implemented in the form of increased insurance premiums, reduction of benefits to employees and dependents, and in the form of cuts in payments to providers. The State Health Plan pays 100% of the health insurance premium for employees and retirees, but employees and

retirees must pay for optional family or dependent coverage. Employer contributions account for 80% of State Health Plan funding. Effective October 1, 2001, the insurance premium for dependent coverage rose by 30%. Net assets increased from a negative \$159.7 million at June 30, 2001 to a negative \$99.4 million at June 30, 2002, an increase (deficit decrease) of \$60.3 million, or 37.7%, with premium revenues for fiscal year 2002 rising to \$1.27 billion, an increase of \$331.1 million, or 35.3%. For fiscal year 2002, claims and benefits totaled \$1.18 billion, an increase of \$54.5 million, or 4.8%.

Historically, the State's health benefits package has been a key component of an overall compensation package enabling the State to hire and retain quality personnel.

## ***Debt Administration***

The State's general obligation bonds are rated Aa1 by Moody's, AAA by Standard & Poors, and AAA by Fitch. During the fiscal year, Moody's Investors Services downgraded the State of North Carolina's general obligation rating to Aa1, from AAA. According to Moody's, the primary reasons for the downgrade were the State's continued budget pressure, reliance on non-recurring revenues, and weakened balance sheet. Also, Moody's commented that the task of restoring structural budget balance and rebuilding reserves faces political and economic obstacles.

The favorable ratings have enabled the State to sell its bonds at interest rates considerably below the Bond Buyer's Index, thereby providing substantial savings to North Carolina taxpayers. Approximately 25 percent of all AAA ratings for state and local governments nationwide are located in North Carolina.

## ***Cash Management***

It is the policy of the State that all agencies, institutions, departments, bureaus, boards, commissions and officers of the State shall devise techniques and procedures for the receipt, deposit and disbursement of monies coming into their control and custody which are designed to maximize interest-bearing investment of cash, and to minimize idle and nonproductive cash balances. The State Controller, with the advice and assistance of the State Treasurer, the State Budget Officer, and the State Auditor, develops, implements, and amends the *Statewide Cash Management Policy*. All cash deposited with the State Treasurer by State entities is managed in pooled investment accounts to maximize interest earnings. During fiscal year 2002, uncommitted State funds were invested in short-term and medium-term U.S. Government notes and bonds, as well as other deposits, which had a composite average yield of 5.38%.

## ***Risk Management***

The State maintains self-insurance programs for employee health; general liability; medical malpractice; workers' compensation; and automobile, fire and other property losses. The State limits its risk for general liability; medical malpractice; and automobile fire and other property losses by purchasing private insurance for losses in excess of deductibles. See Note 12 of the Notes to the Financial Statements for a full description of the State's risk management program.

## ***Other Information***

## ***Independent Audit***

In compliance with State statute, an annual financial audit of the State reporting entity is completed each year by the North Carolina Office of the State Auditor. The Auditor's examination was conducted in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and his opinion has been included in this report. In addition, the State coordinates the *Single Audit* effort of all federal funds through the State Auditor.



## *Certificate of Achievement*

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to the State of North Carolina for its comprehensive annual financial report (CAFR) for the fiscal year ended June 30, 2001. The Certificate of Achievement is a prestigious national award recognizing conformance with the highest standards for preparation of state and local government financial reports.

In order to be awarded a Certificate of Achievement, a government unit must publish an easily readable and efficiently organized comprehensive annual financial report, whose contents conform to program standards. The CAFR must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. We believe our current report continues to conform to the Certificate of Achievement program requirements, and we are submitting it to GFOA.

## *Acknowledgments*

In conclusion, we believe this report provides useful data to all parties using it in evaluating the financial activity of the State of North Carolina. We in the Office of the State Controller express our appreciation to the financial officers throughout State government and to the Office of the State Auditor for their dedicated efforts in assisting us in the preparation of this report. Any questions concerning the information contained in this Comprehensive Annual Financial Report should be directed to the Office of the State Controller at (919) 981-5454.

Respectfully submitted,



Robert L. Powell  
State Controller

December 12, 2002

THIS PAGE INTENTIONALLY LEFT BLANK.

# CERTIFICATE OF ACHIEVEMENT

---

# Certificate of Achievement for Excellence in Financial Reporting

Presented to

State of  
North Carolina

For its Comprehensive Annual  
Financial Report  
for the Fiscal Year Ended  
June 30, 2001

A Certificate of Achievement for Excellence in Financial Reporting is presented by the Government Finance Officers Association of the United States and Canada to government units and public employee retirement systems whose comprehensive annual financial reports (CAFRs) achieve the highest standards in government accounting and financial reporting.



*Thomas A. Brown*  
President

*Jeffrey L. Esser*  
Executive Director